JUL 25 1958
JOHN T. FEY, Clerk

IN THE

Supreme Court of the United States

October Term, 1958.

No. 218

EMORY W. PARSONS and ERMA M. PARSONS,
Petitioners,

v.

FRANCIS R. SMITH, Former Collector of Internal Revenue for the First District of Pennsylvania,
Respondent.

No.

HOWARD H. PARSONS and MARTHA PARSONS,
Petitioners,

v.

FRANCIS R. SMITH, Former Collector of Internal Revenue for the First District of Pennsylvania,
Respondent.

No.

LAWRENCE H. PARSONS and GRACE E. PARSONS,
Petitioners,

v.

FRANCIS R. SMITH, Former Collector of Internal Revenue for the First District of Pennsylvania,
Respondent.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

Emory W. Parsons, Erma M. Parsons, Howard H. Parsons, Martha Parsons, Lawrence H. Parsons, and Grace E. Parsons pray that writs of certiorari issue to review the judgments of the United States Court of Appeals for the Third Circuit entered in three cases, *viz., Emory W. Parsons and Erma M. Parsons v. Smith, Howard H. Parsons and Martha Parsons v. Smith,* and *Lawrence H. Parsons and Grace E. Parsons v. Smith,* on March 27, 1958. Since they involve identical questions, this petition covers all three cases.

OPINIONS BELOW.

The three cases with respect to which writs of certiorari are here sought were consolidated for trial before the United States District Court for the Eastern District of Pennsylvania and, upon appeal, were consolidated for hearing before the Court of Appeals. The opinion of the District Court (8a),[1] which was not reported officially, is unofficially reported in 1957 P-H Fed. Tax Serv. ¶ 72,761. The opinion of the Court of Appeals affirming the District Court is printed in Appendix B, *infra* page 21, and is reported unofficially in 1 AFTR 2d 58-1266. The opinion of the Court of Appeals denying petitioners' petition for rehearing is printed in Appendix D, *infra* page 30, and is reported unofficially in 1 AFTR 2d 58-1829. Judge Kalodner dissented from the Court of Appeals' denial of the petition for rehearing, stating that his views are expressed at length in his dissenting opinion rendered in connection

1. This and similar references are to page numbers of the petitioners' Appendix filed with the Court of Appeals.

with the Court of Appeals' denial of a petition for rehearing in *Huss, et al. v. Smith.* Judge Kalodner's dissenting opinion in *Huss,* which was decided against the taxpayers in that case on the same day as the present case, is set forth in full in Appendix. F, *infra* page 32.[2] Counsel for petitioners are advised that the taxpayers in *Huss* also propose to file a petition for writ of certiorari with this Court.

JURISDICTION.

The judgments of the Court of Appeals, printed in Appendix C, *infra* page 28, were entered on March 27, 1958. A petition for rehearing, timely filed before April 25, 1958 pursuant to order of the Court dated April 10, 1958, was denied May 29, 1958. The order denying the petition for rehearing is printed in Appendix E, *infra* p. 31.

Petitioners invoke the jurisdiction of this Court under Section 1254(1) of the Judicial Code, 28 U. S. C. § 1254(1).

QUESTION PRESENTED.

Whether the Court of Appeals for the Third Circuit erred in holding that a partnership in the business of strip mining coal had no depletable economic interest in the coal because its agreement with the owner was terminable by either party upon ten days' notice, and because it was paid a stated price per ton for coal delivered to the owner; notwithstanding the fact (which the dissent below considered controlling) that it had the exclusive right to mine to exhaustion all coal uncovered by it, bore the entire risk of the enterprise, and was paid only for merchantable coal discovered and delivered.

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2. The opinion of the Court of Appeals in the *Huss* case is reported unofficially in 1 AFTR 2d 58-1264, and the Court's opinion upon its denial of petition for rehearing is reported unofficially in 1 AFTR 2d 58-1834.

STATUTES AND REGULATIONS INVOLVED.

The statutory provisions involved are Sections 23(m), 23(n), and 114(b)(4) of the Internal Revenue Code of 1939, 26 U.S.C. § § 23(m), (n), 114(b)(4). They are printed in Appendix A, *infra* page 19.[3] The regulations involved are Treasury Regulations 111, 26 *Code Fed. Regs.* § 29.23 (m)-1 (1949). They are printed in Appendix A, *infra* page 20.

STATEMENT OF THE CASE.

A. The Nature of the Proceeding.

These cases involve suits for refund of income taxes paid with respect to the calendar years 1945 through 1949, and aggregating approximately $63,000.

During the taxable years in question Emory W. Parsons, Howard H. Parsons and Lawrence H. Parsons were partners in an enterprise engaged in the business of strip mining coal in the bituminous regions of Pennsylvania. In the partnership returns filed for the taxable years, no depletion allowance was claimed in respect of the partnership's gross income from the mining, thereby increasing each partner's share of the partnership net distributable income required to be reported in his individual joint income tax return. The partners (joined by their respective wives) individually filed refund claims for the resultant overpayment of income tax, and upon disallowance thereof, pursuant to Section 1340 of the Judicial Code, 28 U. S. C. § 1340, commenced suit in the District Court to recover

3. The provisions of the Internal Revenue Code cited are those applicable to the taxable years here involved. There has been no substantial change in those provisions affecting the question presented by this case. Compare Sections 611(a) and 613 of the Internal Revenue Code of 1954, 26 U. S. C. §§ 611(a), 613.

the tax from the Collector of Internal Revenue to whom it had been paid. The District Court entered judgment for the defendant, and the Court of Appeals affirmed.

The sole issue is whether the Court of Appeals was correct in holding that the partnership was entitled to no deduction for percentage depletion with respect to amounts received by it from the owner of the coal lands in payment for coal delivered during the taxable years in question. Decision of this issue turns upon the basic question whether the partnership had an economic interest in the coal in place during such years. *Kirby Petroleum Company v. Commissioner*, 326 U. S. 599 (1946).

B. Facts.

The facts of this case, as found by the District Court, are as follows:

During the taxable years in question, Emory W. Parsons, Howard H. Parsons and Lawrence H. Parsons were members of a partnership ("Parsons") engaged in removing overburden and strip mining coal on the property of Rockhill Coal Company ("Rockhill") under an oral agreement entered into in 1942. The areas to be stripped were selected by Rockhill's engineering department after consultation with Parsons, and, generally, prospecting was 60% successful (8a, 12a, 14a, 18a, 19a).

The oral agreement could be terminated by either party on ten days' notice. However, if Rockhill cancelled on ten days' notice and Parsons had previously gone to the expense of removing the overburden (thereby performing the heavy part of the work, as well as meeting wages and expenses in so doing), then Parsons would have the privilege of taking out the coal under the above mentioned, removed overburden and of being paid for it, even though this took more than ten days. Parsons was not bound to remain until the prospected coal was exhausted. It had the right, however, to stay and take out from the coal it found

as much coal as it economically could take out at a profit with its equipment (14a, 15a).

The amount of equipment, the number of its employees, and the quantity of coal stripped (subject to Rockhill's right of termination) were in the discretion of Parsons. The equipment used by Parsons either belonged to it or was leased from Rockhill, and Parsons bore the entire expense of the operation. Parsons was paid a stated amount per ton of coal delivered to Rockhill's railroad cars, subject to increase to reflect its costs (15a, 16a, 21a-22a).

On August 1, 1950 Parsons gave Rockhill notice that it intended to cease its operations. Thereafter it continued to strip mine coal that had been cleared of overburden until September 5, 1950, when no coal was left uncovered (24a).

C. Decisions of the Courts Below.

On the basis of the foregoing facts, the District Court held that Parsons had no economic interest in the coal mined by it during the taxable years and, consequently, was entitled to no allowance for percentage depletion. The Court based its decision upon three grounds:

(1) Parsons' contract was terminable by Rockhill upon ten days' notice (26a);

(2) Parsons was paid a stated price per ton, irrespective of the market price (26a); and

(3) The coal remained an asset of Rockhill (28a).

In affirming the judgment of the District Court, the Court of Appeals adopted the first two of the foregoing grounds relied upon by the District Court, and ignored the third. The latter action was eminently proper, for it is well settled that the term "economic interest" does not mean title to, or ownership of, the mineral. *Palmer v. Bender*, 287 U. S. 551, 557 (1933). However, the Court of

Appeals commented upon a third factor which, it said, "deserves separate mention", *viz.*, that Parsons had no capital investment in the coal beyond the contribution of depreciable equipment suitable for other uses.

Judge Kalodner dissented from the Court of Appeals' denial of petition for rehearing, incorporating by reference his views expressed in *Huss*, and stating (*infra*, p. 30):

> "The taxpayers here, as in the Huss cases, were granted an exclusive right to remove all the merchantable coal in place in the reserved or leased area. They had a right of control over production of the mineral in place which gives rise to the economic interest necessary for the depletion allowance. Burton-Sutton Oil Company v. Commissioner, 328 U. S. 25, 29, 32 (1946). All the coal involved was produced during the existence of this interest. The fact that such interest might have been brought to an end someday in the future is not a relevant consideration."

D. Petitioners' Position.

No case involving the right of coal strippers to depletion allowances has yet been decided by this Court. However, in many oil and gas cases this Court has often stated that the taxpayer owns the requisite economic interest if his income is dependent solely upon production of the mineral. Most recently, in *Commissioner v. Southwest Exploration Company*, 350 U. S. 308 (1956), the Court determined that coastal land owners who permitted operators the use of their land in reaching off-shore oil deposits had an economic interest in the deposits. As required by state law, the operators obtained from the coastal land owners the right to erect drilling equipment on their land and, by a process known as whipstocking, reached the oil deposit in the ocean. Neither the land owners nor the operators supposed that the former had any oil on their land, and, indeed, the operations were designed to, and did, reach oil which

was not on their lands. This Court held that the land owners had an economic interest in the oil:

> "Their contribution [of land] was an investment in the oil in place sufficient to establish their economic interest. Their income was dependent entirely on production, and the value of their interest decreased with each barrel of oil produced. No more is required by any of the earlier cases."

The lower courts have applied the same basic test to coal strippers. In *Commissioner v. Gregory Run Coal Company*, 212 F. 2d 52 (4th Cir. 1954),[4] the Court of Appeals stated, in holding that the coal strippers in that case were entitled to depletion deductions:

> "We think, however, that in the pending case the rights of the producers were completely dependent upon the extraction of the salable product and that consequently they were entitled to share in the benefits of the statute which were designed to give compensation to persons interested in the production of a wasting asset."

It is petitioners' position that Parsons falls four square within the principles enunciated by this Court. Parsons bore the entire cost of the stripping operation, with no expectation of income unless and until it succeeded in discovering and delivering coal to Rockhill. Since Parsons' income was dependent solely upon the production of coal, it is accordingly entitled to the depletion allowances.

It is further petitioners' position that denial of the depletion deductions to Parsons would defeat the fundamental purpose of the depletion allowance and the Congressional intent in enacting the depletion provisions of the revenue laws. Congress intended the depletion allowance

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4. Cert. den., 348 U. S. 828 (1954).

to compensate those who bear the risk of discovering minerals.[5] Under its contract Parsons was burdened with all the risk, and received no income whatever until it was successful in finding and producing marketable coal. Manifestly, therefore, to it must belong the compensation provided by Congress for entrepeneurs who prospect for and produce minerals at the risk of losing their entire investment if they are unsuccessful.

REASONS FOR GRANTING THE WRITS.

I. The Decision of the Court of Appeals Below Is Squarely in Conflict With the Decisions of the Court of Appeals for the Fourth Circuit.

As stated heretofore, the Court of Appeals relied principally upon two grounds: (1) that Parsons' contract was terminable upon ten days' notice (*infra*, p. 24), and (2) that Parsons was paid a stated price per ton for coal mined and delivered to Rockhill (*infra*, p. 24). On both counts the Court of Appeals is in direct conflict with the decisions of the Court of Appeals for the Fourth Circuit holding that neither factor deprives the coal stripper of his economic interest.

A. *The Termination Clause.* In discussing the Fourth Circuit's decisions with respect to terminability, the Court of Appeals sought to evade their impact by terming them "borderline cases" (*infra*, p. 25). It is difficult to conceive, however, of a decision more squarely in point and more contrary to the present decision than the Fourth Circuit's holding in *Weirton Ice and Coal Supply Company v. Commissioner*, 231 F. 2d 531, 535-36 (4th Cir. 1956), wherein the Court stated:

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5. Sen. Rep. No. 617, 65th Cong., 3rd Sess., 1939-1 (Part 2) Cum. Bull. 122; H. R. Rep. No. 1, 69th Cong., 1st Sess., 1939-1 (Part 2) Cum. Bull. 319.

> "No stronger proof that Weirton had in effect the right to mine the coal could be found than in its willingness to invest $500,000 in the enterprise. *It is of no moment that the owner of the mineral, as in other cases in which the right of an extractor to a deduction for depletion has been upheld, had the option to terminate the arrangement at any time, for as the event proved, Weirton actually mined the coal during all of the taxable years.* We think that Weirton's rights were dependent solely upon the extraction and delivery of the coal, and that the relationship of the parties to the ore in place gave it an economic interest in the mineral and entitled it to share with National the depletion allowance provided by the statute." (Emphasis added)

See also *Hamill Coal Corp. v. Commissioner*, 239 F. 2d 347 (4th Cir. 1956) (stripper had economic interest where contract terminable upon ninety days' notice); *Commissioner v. Gregory Run Coal Company, supra* (stripper had economic interest where contract terminable upon thirty days' notice).

The disagreement between the Circuits with respect to terminability centers upon their divergent views as to the significance of the fact that the coal strippers involved actually mined all the coal in respect of which depletion allowances are sought. Under Parsons' contract it had an indefeasible right to remove all coal uncovered in the course of its operation, even though this required more than ten days. Notwithstanding this fact and the fact that Parsons seeks depletion allowances only as to coal actually mined and delivered, the Court of Appeals below thought that Rockhill's unexercised right to prevent further mining at some indefinite future time was of crucial importance in determining whether Parsons possessed the requisite economic interest. The Court of Appeals for the Fourth Circuit takes a more realistic view which accords with the

decisions of this Court. It holds that if the stripper's income is dependent entirely upon production, it owns the requisite economic interest in all the coal which it in fact mines. Of necessity, therefore, the owner's right to terminate the contract as to coal yet undiscovered and unmined has no relevance.

In his dissenting opinion in *Huss*, Judge Kalodner succinctly underlined the disparity between the Circuits in recording his agreement with the holdings of the Fourth Circuit (*infra*, pp. 33-4).[6]

> "Nothing was said by the Supreme Court in [the Southwest] case on the score as to the impact of a right of termination of a contract creating an economic interest on the existence of that interest in the first place. Nor has the Supreme Court said so in any other case. We did not consider nor did we pass upon this question in Commissioner v. Mammoth Coal, 229 F. 2d 255 (1955). Nor has any other appellate court done so, except the Fourth Circuit. That Circuit, however, has explicitly ruled that a right of termination does not destroy an economic interest which existed prior to its exercise. It did so in two cases: Weirton Ice and Coal Supply Co. v. Commissioner, 231 F. 2d 531, 533 (1956) and Commissioner v. Hamill Coal Corp., 239 F. 2d 347 (1956).
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> "I agree with the view of the Fourth Circuit that the right of termination does not affect a stripper's right to depletion where the requisite economic interest as defined by the Supreme Court exists. The Commis-

6. The language of the Court of Appeals for the Ninth Circuit in *Usibelli v. Commissioner*, 229 F. 2d 539 (9th Cir. 1955), indicates that Court may be in accord with the view of the Third Circuit with respect to the importance of terminability of the contract. As the Fourth Circuit pointed out in *Weirton*, however (231 F. 2d at 536), *Usibelli* involved a wholly different factual situation in that the stripper was not dependent upon discovery of coal for its income, but was paid a fixed price each year.

sioner and the courts must deal with a situation as it exists during the taxable year involved and not as it might exist in some future year because of the possible occurrence of an event through the exercise of a contractual right."

B. *The Method of Payment.* The second major ground relied upon by the Court of Appeals was that Parsons was paid a stated price per ton of coal mined and delivered to Rockhill. Since these payments did not fluctuate with the market price, the Court concluded that Parsons had no economic interest in the coal (*infra*, p. 24). This view is squarely in conflict with the decisions of the Fourth Circuit on this point.

In *Weirton* the stripper received a stated price per ton subject, as here, to adjustment to reflect increases or decreases in his labor costs. The Fourth Circuit held the stripper entitled to depletion allowances, relying upon its earlier decision in *Gregory Run*, which had expressly held that such a method of payment does not defeat an economic interest.

We believe that the view of the Court of Appeals for the Third Circuit is demonstrably erroneous. It is clear that Congress intended to compensate those who bear the risk of discovery of the mineral. Once the coal is above the ground the risks are those of sale, a problem inherent in all businesses, and therefore not warranting a special reward. Since the depletion allowance was not intended to reward businesses for assuming the risks of the market, it is obvious that the coal stripper need not assume the risk of the market in order to receive a depletion deduction.

The decision of the Court of Appeals below not only collided with the holdings of the Fourth Circuit, but also emasculated its own previous decision in *Commissioner v. Mammoth Coal Company*, 229 F. 2d 535 (3d Cir. 1955).[7] Earlier the Court had stated:

7. Rehearing denied, 229 F. 2d 539 (1956), cert. den., 352 U. S. 824 (1956).

> "The fact that, instead of retaining coal, the stripper received so much per ton for that coal which first had to be offered to and accepted by the [owner] should make no difference, for in any event the stripper had to look to the coal which it mined for return of its investment and profit."

The Court's tacit reversal of *Mammoth* is all the more difficult to understand in view of the fact that both parties conceded on brief that the method of payment is irrelevant.

The conflict caused by the Court of Appeals' surprising resurrection of this issue was recognized by Judge Kalodner in his dissent in *Huss*:

> "There is also no room for doubt that the taxpayers depend solely upon production for their return, since they received only the agreed price per ton for coal produced and delivered. Indeed, they bore all risks of mining, including, but not limited to, the finding and production of commercial quality coal in such quantities necessary to make operation profitable.
>
> "Until now, every appellate decision in this type of case, including our own decision in Commissioner v. Mammoth Coal Co., supra, has held that there is no requirement that the stripper must assume the risks of the ultimate market. To the extent that we now hold otherwise, we are in conflict with our decision in that case and with the decisions of the Fourth Circuit. We are also in conflict with the latest pronouncement of the Supreme Court, Commissioner v. Southwest Exploration Co., 350 U. S. at page 314, that the taxpayer must look solely to the extraction of the mineral for his return. That is what the taxpayers here had to do."

The decision of the Court of Appeals in the present case places it in irreconcilable conflict with the holdings of

the Fourth Circuit.[8] Accordingly we respectfully urge the Court to issue the writs of certiorari here sought, and reconcile the conflict by reversing the judgment of the Third Circuit.

II. The Decision of the Court of Appeals Is in Direct Conflict With the Decisions of This Court.

In view of what has been said heretofore, it requires little further discussion to demonstrate that the decision of the Court of Appeals in the present case is a radical departure from the principles enunciated by this Court in its many decisions dealing with depletion of oil and gas interests. In *Southwest*, the most recent of these decisions, the Court restated in a few words the two basic essentials of an economic interest as they were originally set forth some tweny-five years ago in the landmark case of *Palmer v. Bender, supra:*

> ". . . a taxpayer is entitled to depletion where he has: (1) 'acquired, by investment, any interest in the oil in place,' and (2) secured by legal relationship 'income derived from the extraction of the oil, to which he must look for a return of his capital.' "

It is clear that Parsons acquired, by investment, an interest in the mineral. As this Court has often pointed out, no legal title to, or ownership of, the mineral need be acquired by such investment. As was stated in *Southwest*,

8. After the present case was submitted to the Court of Appeals below, the Fourth Circuit decided *Stilwell v. United States*, 250 F. 2d 736 (4th Cir. 1957). That case, which was brought to the attention of the Court by the petitioners and the Department of Justice, held that the stripper had an economic interest under circumstances where the contract was not terminable and the price varied with the market. This holding, of course, is not in the least inconsistent with the Court's previous decision in *Weirton*, where it was held that the stripper's economic interest is not defeated by the fact that his contract is terminable or that his price does not vary with the market.

"The allowance continues so long as minerals are extracted, and even though no money was actually invested in the deposit."[9] It is the dedication of assets to the enterprise, in precisely the manner found here, which Congress sought to encourage. Thus Parsons' investment was its commitment of its know-how, payroll, and equipment on the gamble that marketable coal could be discovered and exploited.

Second, it is plain beyond argument that Parsons could look only to the income from extraction of the coal for its return. Since it was paid only upon the delivery of marketable coal to Rockhill, it is obvious that its income was dependent solely upon the discovery and production of coal. This factor is the heart of the issue and has been emphasized by every previous decision, almost to the exclusion of other possible factors. It was, however, virtually ignored by the Court of Appeals below.

The Court of Appeals thought that Parsons' investment was insufficient because its equipment was suitable for another use, and because it could recoup its investment through deductions for depreciation. There is a short answer to this. If this view were correct, it would inescapably follow that *no* stripper (nor, indeed, any operator drilling an oil well on leased land) would be entitled to depletion. Almost all stripping equipment can be used in other businesses, and it is all depreciable. Logic dictates that the Court of Appeals repudiate all the decided cases (its own included) allowing depletion to coal strippers.

It is apparent that the decision of the Court of Appeals is in conflict with the applicable decisions of this Court, and for this reason we respectfully urge the Court to issue the writs of certiorari here sought.

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9. 350 U. S. 308, 312.

III. Determination of the Relative Rights of the Owner and Strip Miner to Percentage Depletion Is a Question of Importance in the Adminstration of the Federal Income Tax Laws Which Has Not Been, But Should Be, Settled By This Court.

While this Court has had occasion to consider the application of the depletion provisions of the Internal Revenue Code in many cases involving oil and gas properties, to date it has not considered the relative rights of parties involved in the production of coal. The strip miner has in recent years become a significant adjunct of the coal mining industry, and the respective rights of the owner of the coal lands and the stripper to claim allowance for percentage depletion for Federal income tax purposes have accordingly given rise to a vast amount of litigation. Since the question concerns the legal conclusion to be drawn from the particular facts of each case, there has developed, as might be expected, much confusion in the lower courts with respect to the importance and significance of various factors. The present case is an example. Here the Court of Appeals for the Third Circuit leaned heavily upon two factors which the Fourth Circuit considers irrelevant.

The confusion has been compounded by the fact that the depletion allowance may be apportioned between the owner and the stripper. Thus, if it is found that the stripper has an economic interest in the coal, the owner, in computing his "gross income from mining" for purposes of his percentage depletion allowance, must eliminate the amounts paid to the stripper. The amounts received by the stripper are in turn his "gross income from mining" upon which he computes his percentage allowance. This arrangement permits an aggregate depletion allowance upon only the gross income realized upon sale of the coal, and the revenues of the Treasury are not impaired. The Treasury's main concern lies in preventing *both* owner and stripper from claiming depletion allowances on their

full gross incomes, thus resulting (to the extent of the payments by the owner to the stripper) in the allowance of depletion in respect of the same money twice. This concern has often led to the anomalous situation where the Treasury may be arguing on behalf of the stripper in one case, and on behalf of the owner in another. Once again, the two cases arising in the Third Circuit are excellent examples. In *Mammoth* the Treasury successfully argued that the stripper had an economic interest whereas, in contrast, in the present case it contends it does not.

The effect of the foregoing upon the administration of the tax laws is obvious. Taxpayers and Treasury representatives have no guide, short of litigation, by which differences between them in this field may be administratively adjusted. The Treasury is understandably reluctant to settle with one party (either owner or stripper) because it may thereafter be met with a claim by the other without adequate standards with which to deal with it. Furthermore, taxpayers lack standards by which their own arrangements may be satisfactorily made.

In a word, this important area of the law urgently requires consideration by this Court, and the establishment of clear rules for the guidance of taxpayers and the Treasury alike. For this reason, we respectfully urge the Court to issue the writs of certiorari here sought.

CONCLUSION.

We wholeheartedly concur in the view expressed by Judge Kalodner in his dissent in *Huss:*

> "I conclude, therefore, that the taxpayers during the taxable years involved had the requisite economic interest in the coal in place. This, to me, is the result required by the decisions of the Supreme Court, the Fourth Circuit, and this Court; and our present decision is inconsistent therewith."

For the foregoing reasons, it is submitted that this petition for writs of certiorari should be granted.

Respectfully submitted,

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APPENDIX A.

Internal Revenue Code of 1939.

§ 23. Deductions from gross income.

In computing net income there shall be allowed as deductions:

* * * * * *

(m) Depletion.

In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for a depreciation of improvements, according to the peculiar conditions in each case * * *.

(n) Basis for depreciation and depletion.

The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in Section 114.

§ 114. Basis for depreciation and depletion.

* * * * * *

(b) Basis for Depletion.

* * * * * *

(4) Percentage Depletion for Coal * * *—(A) In General.

The allowance for depletion under section 23(m) shall be, in the case of coal mines, 5 per centum * * * of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * *

(B) Definition of gross income from property.

As used in this paragraph the term "gross income from the property" means the gross income from mining. The term "mining", as used herein, shall be considered to include

not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products. The term "ordinary treatment processes", as used herein, shall include the following: (i) In the case of coal—cleaning, breaking, sizing, and loading for shipment * * *.

Treasury Regulations 111.

§ 29.23(m)-1. Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Timber; Depreciation of Improvements. Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. * * * An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

APPENDIX B.

Opinion of the Court Below.

Before: BIGGS, *Chief Judge*; and GOODRICH and HASTIE, *Circuit Judges*.

These are appeals by taxpayers, who are partners in a business, from a judgment of the district court denying their several claims for refunds of income taxes paid upon their respective distributable shares of certain partnership income derived from coal mining. The appellants can prevail only if the involvement of the partnership, hereinafter called Parsons, in a strip mining enterprise was such as to entitle the partners to deduct a depletion allowance, pursuant to Sections 23 (m) and 114 (b) of the Internal Revenue Code of 1939 as implemented by Treasury Regulation 111, § 29.23 (m)-1, 26 CODE FED. REG., 1949 ed., § 29.23 (m)-1, in computing partnership income from the mining operation. The problem presented is the often difficult, though familiar and recurring one of determining whether the person claiming a depletion allowance is "the owner of an economic interest in mineral deposits" within the meaning of Treasury Regulation 111, § 29.23 (m)-1.[1]

The almost simultaneous recent decisions of this court in *Commissioner of Internal Revenue v. Mammoth Coal Co.*,

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1. ". . . .

"Under such provisions [Secs. 23 (m) and 114], the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. . . . An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production." 26 CODE FED. REG., 1949 ed., § 29.23 (m)-1.

1955, 299 F.2d 535, cert. denied 352 U.S. 824, and of the Court of Appeals for the Ninth Circuit in *Usibelli v. Commissioner of Internal Revenue*, 1955, 229 F.2d 539, have gone so thoroughly into this tax problem as it arises in the context of strip mining that we shall not elaborate again the basic concepts which are discussed in those cases. It is enough to repeat that the decisions make it clear that the economic interest in coal in place which will support a percentage depletion allowance for strip mining need not amount to an estate or tenancy as understood in the law of real property. Yet, it must be something more than an independent contractor's normal right to the benefit of his bargain and the kind of "interest" which that right always gives him in the subject matter of the contract. In characterizing an asserted interest a court will be guided by the total picture revealed by the facts of the case at hand.

On this appeal the facts found by the district court are unchallenged. The Parsons firm is a contractor and over the years has engaged in road building, strip mining and the drilling of gas wells. Parsons derived the income involved in this case from strip mining conducted on land owned by the Rockhill Coal Co.

In preliminary negotiations Rockhill had proposed that Parsons undertake extensive stripping of the area in question under a detailed written contract and, to that end, Rockhill actually drafted a proposed contract. But Parsons refused to sign the agreement stating that it did not wish to be bound to a long term performance because, if opportunity should arise, it wished to return to road building. Accordingly, it was agreed that the partnership would proceed with stripping in the designated area under a terminable oral agreement. The essential provisions of that oral contract are set out in the trial findings.

The agreement defined the area to be mined but left the partnership free to work as it chose. The partnership understood that it was not obligated to mine the tract to

exhaustion. Indeed, although operations under the oral agreement were conducted from time to time over an eight year period, the tract still contained much strippable coal when Parsons terminated its operations. Some of this coal was later mined by another contractor. Moreover, it was mutually understood from the beginning, in the light of the already mentioned desire of the partnership to be free to change from stripping to road building on short notice, that either party could terminate the oral agreement on ten days notice. In this connection it was understood that after notice of termination by the landowner the partnership would still be privileged to remove and the landowner obligated to accept usable coal from which the partnership had actually removed the overburden—this constituting the major part of the stripping operation—before the notice was received.

It was agreed that the partnership should deliver the coal it mined to Rockhill's railroad cars and to no one else. In practice any coal which Rockhill rejected as unsuitable for its purposes was left in the pits as unsaleable. The parties agreed in advance upon a stipulated price per ton which Rockhill was to pay Parsons for usable coal. This price was not geared to and did not vary with the market price of coal. However, the price could be and on occasion was altered to reflect increased costs of production.

Parsons made a considerable investment in movable equipment used in the Rockhill stripping operation. Early in the taxable period the partnership committed to this job its own equipment valued at some $210,000. At the same time it was using about $130,000 worth of Rockhill equipment under a rental agreement with the landowner. As the work progressed the partnership rented an increasing amount of Rockhill equipment and used less of its own. There is no indication that the partnership equipment had utility only for this job or was specially adapted to it.

We are satisfied that what the parties agreed and what they did disclose the partnership acting only as an

ordinary independent contractor in mining the Rockhill tract. First, the matter of compensation was handled as in an ordinary contract job. The partnership had no freedom to sell or dispose of the coal to its own account. It was entitled only to an agreed price from the owner of the mining property. And since that price did not fluctuate with the market, there is nothing about the scheme of payment to indicate any interest of the contractor in the mineral. If we ask how this arrangement for payment to the partnership for its work differed from the normal payment as an independent contractor for accomplishing an agreed result, it is immediately apparent that there is no significant difference.

The other important factor on this record is the agreed duration of the enterprise. Here it is noteworthy that the partnership did not enter the job with any understanding that it would mine the tract to exhaustion, and that it did not in fact do so. Rather, it was concerned from the beginning to remain free to discontinue stripping at any time. The terminability of the agreement on short notice was an essential and significant part of the bargain, not a mere formality inserted by some cautious draftsman. The logical conclusion from all of this is that the partnership contemplated and bargained for no economic interest in the mineral it agreed to extract beyond the independent contractor's normal concern with any subject matter with which he is to work for an agreed price. True, the ten day notice could not be used to deprive Parsons of compensation for work it already had done in removing the overburden from particular coal. But this special limited right to complete work already far advanced does not destroy the character of the contract as one deliberately made terminable on very short notice.

The cases support this view of the matter. While the courts characteristically look at the entire context in deciding whether mining contractors have depletable interests in the mineral in place, the stripper usually bases his claim

upon one or both of the factors discussed above. In some circumstances the stripper's right to mine the deposit to exhaustion, or even for a rather considerable period without particular reference to exhaustion, is stressed. See *Commissioner of Internal Revenue v. Mammoth Coal Co., supra; Stilwell v. United States,* 4th Cir., 1957, 250 F.2d 736; *Winfield Mining & Contracting Co.,* 1954, 13 TCM 571; *James Ruston,* 1952, 19 T.C. 284; *cf.* G.C.M. 26290, 1950-1 CUM. BULL. 42. In others the fact that the stripper's income from the mining operation varies in accordance with the market price of the mineral makes his claim of depletable interest persuasive. See *Commissioner of Internal Revenue v. Gregory Run Coal Co.,* 4th Cir. 1954, 212 F.2d 52, *cert. denied,* 348 U.S. 828 (Vincent-Swaney contract); *Virginia B. Coal Co.,* 1956, 25 T.C. 899; *Paul E. Barry, Inc.,* 1955, 14 TCM 37; *Winfield Mining & Contracting Co., supra; James Ruston, supra.* But see *C. A. Hughes & Co.,* 1955, 14 TCM 172. But unless some such special circumstance appears, differentiating the arrangement from the ordinary contract job, there is analytically no basis upon which the stripper, who has no conventional property in the mineral, can claim a depletable interest therein.

Appellants attach much significance to recent borderline cases in which the Court of Appeals for the Fourth Circuit has found that contractors engaged in strip mining on land of others were entitled to depletion allowances. See *Stilwell v. United States, supra; Commissioner of Internal Revenue v. Gregory Run Coal Co., supra; Weirton Ice & Coal Supply Co. v. Commissioner of Internal Revenue,* 4th Cir. 1956, 231 F.2d 531; *Commissioner of Internal Revenue v. Hamill Coal Corp.,* 4th Cir. 1956, 239 F. 2d. 347. That court has certainly gone as far as any other in recognizing depletable interests in strippers. But in the cited Fourth Circuit decisions we find repeated emphasis upon the court's factual conclusion that the real understanding of the parties was that the strip miners would be allowed to exhaust the mineral, or at least to continue stripping oper-

ations for a very substantial time. Only in one of the arrangements considered in *Commissioner of Internal Revenue v. Gregory Run Coal Co., supra,* does this factor seem to have been absent. And there the owner and the strip miner had formalized their relationship in an agreement terming the strip mining project "this joint adventure." How much weight the court accorded this indication of the way the parties themselves viewed their relationship, we do not know. Perhaps no more can be said than that distinguishing facts usually prevent reasoning by analogy from being very helpful in borderline cases. In any event, we think the reasoning of the Fourth Circuit cases requires the stripper to marshal more significant indicia of interest in the mineral than the present record will yield.

One other point deserves separate mention. In these mining cases the allowance of a percentage depletion deduction from gross income for tax purposes is premised on the conception that a tax free recovery of capital actually invested in a wasting mineral deposit is fair. See *Commissioner of Internal Revenue v. Southwest Exploration Co.,* 1956, 350 U.S. 308, 312. The commitment of capital as an investment in the exploitation of a given mineral deposit must be real and unequivocal. Otherwise, mining contractors, like contractors generally, must look to "receive their tax benefit through depreciation and obsolescence allowances, and not through an allowance for the depletion of the mineral deposit on which they happen to be working." See *Usibelli v. Commissioner of Internal Revenue, supra,* 229 F.2d at 541.

Here the only thing set up as a capital investment in the Rockhill coal deposits is Parsons' purchase of a considerable quantity of movable equipment, accompanied by the rental of other equipment from Rockhill. There has been no showing that this equipment was specially adapted to this job or that it would not be suitable thereafter for such other undertakings as constituted the normal and familiar business of this contractor. Thus, quite apart from

considerations relating to compensation and the terminability of the contract, it is very doubtful whether investment in equipment of general utility in a contractor's business is the type of capital expenditure which can properly be found to constitute an investment in a particular mineral deposit which the contractor has undertaken to work.

For these reasons we agree with the district court that the tax refund claims in suit are not well founded.

The judgment will be affirmed.

APPENDIX C.

Judgments of the Court Below.

No. 12,299.

Present: BIGGS, *Chief Judge,* GOODRICH and HASTIE, *Circuit Judges*

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this case be, and the same is hereby affirmed.

Attest:

IDA O. CRESKOFF
Clerk

March 27, 1958

No. 12,300.

Present: BIGGS, *Chief Judge* and GOODRICH and HASTIE, *Circuit Judges.*

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this case be, and the same is hereby affirmed.

Attest:

IDA O. CRESKOFF
Clerk

March 27, 1958

No. 12,301.

Present: BIGGS, *Chief Judge* and GOODRICH and HASTIE, *Circuit Judges.*

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this case be, and the same is hereby affirmed.

Attest:

IDA O. CRESKOFF
Clerk

March 27, 1958.

APPENDIX D.

Opinion of the Court Below on Petition for Rehearing.

Present: BIGGS, *Chief Judge;* and MARIS, GOODRICH, STALEY and HASTIE, *Circuit Judges.*

PER CURIAM:

This petition for rehearing raises no point of substance that has not already been considered and decided against the petitioner. Accordingly, the petition is denied.

KALODNER, *Circuit Judge,* dissenting.

I am of the opinion that a rehearing should be granted, and the judgment of the district court reversed.

This result is required for the reasons I have given in my dissenting opinion in the Huss cases.

The taxpayers here, as in the Huss cases, were granted an exclusive right to remove all the merchantable coal in place in the reserved or leased area. They had a right of control over production of the mineral in place which gives rise to the economic interest necessary for the depletion allowance. Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 29, 32 (1946). All the coal involved was produced during the existence of this interest. The fact that such interest might have been brought to an end some day in the future is not a relevant consideration.

APPENDIX E.

Order Sur Petition for Rehearing.

Present: BIGGS, *Chief Judge;* and MARIS, GOODRICH, STALEY and HASTIE, *Circuit Judges.*

After due consideration the petition for rehearing in the above-entitled cases is hereby denied.

Attest:

IDA O. CRESKOFF
Clerk

Dated:

May 29, 1958

APPENDIX F.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 12,315

No. 12,317

No. 12,319

GEORGE HUSS,
Appellant in No. 12,315

RUSSELL HUSS,
Appellant in No. 12,317

WESLEY HUSS,
Appellant in No. 12,319

v.

FRANCIS R. SMITH, COLLECTOR OF INTERNAL REVENUE,
FIRST DISTRICT OF PENNSYLVANIA

SUR PETITION FOR REHEARING

Present: BIGGS, *Chief Judge;* and MARIS, GOODRICH, STALEY and HASTIE, *Circuit Judges.*

Opinion of the Court

(Filed May 29, 1958)

• • •

KALODNER, *Circuit Judge,* dissenting.

I would grant the petition for rehearing. Further, on rehearing I would reverse the judgment of the district court on the principal issue involved—the existence of an economic interest.

The Supreme Court has charted the course and the law in cases of this type. Only recently it stated, firmly and concisely, that a taxpayer is entitled to the depletion deduction "where he has: (1) 'acquired, by investment, any interest in the oil in place', and (2) secured by legal relationship 'income derived from the extraction of the oil, to which he must look for a return of his capital' ". Commissioner v. Southwest Exploration Co., 350 U.S. 308, 314 (1956).

"These two factors usually considered together", said the Supreme Court in the Southwest Exploration case, "constitute the requirement of 'an economic interest.' "

Nothing was said by the Supreme Court in that case on the score as to the impact of a right of termination of a contract creating an economic interest on the existence of that interest in the first place. Nor has the Supreme Court said so in any other case. We did not consider nor did we pass upon this question in Commissioner v. Mammoth Coal, 229 F.2d 255 (1955). Nor has any other appellate court done so except the Fourth Circuit. That Circuit, however, has explicitly ruled that a right of termination does not destroy an economic interest which existed prior to its exercise. It did so in two cases: Weirton Ice and Coal Supply Co. v. Commissioner, 231 F.2d 531, 533 (1956) and Commissioner v. Hamill Coal Corp., 239 F.2d 347 (1956).

In Weirton it was said (p. 535):

> "It is of no moment that the owner of the mineral, as in other cases in which the right of an extractor to a deduction for depletion has been upheld, had the option to terminate the arrangement at any time, for as the event proved, Weirton actually mined the coal during all the taxable years."

In Hamill, the contract (entered into in 1944) was to continue for one year and from year to year thereafter with the right of either party to terminate it at any time upon 90 days' written notice. The contract was terminated in 1947 by mutual agreement "after Daniel [the stripper] had removed substantially all the coal with an overburden of less than 40 feet." (p. 349).

In Weirton the decision does not disclose when mining operation ceased or whether the stripper ever mined to exhaustion. In Hamill, however, the record discloses that subsequent to termination the owner of the mine actually mined some 90,000 tons of coal.

In the instant case it is undisputed that the stripper (taxpayers) mined to exhaustion and that the contracts were terminated by mutual agreement after such exhaustion so that the factual situation here is much stronger than in either Weirton or Hamill.

I agree with the view of the Fourth Circuit that the right of termination does not affect a stripper's right to depletion where the requisite economic interest as defined by the Supreme Court exists. The Commissioner and the courts must deal with a situation as it exists during the taxable year involved and not as it might exist in some future year because of the possible occurrence of an event through the exercise of a contractual right.

It is not necessary, however, that I go as far along the course stated in the decision of the instant case. The record here discloses that the termination clause was included in the contract as a precaution on the part of the

owner to protect itself from possible difficulties with an incompetent stripper.[1] It may be noted parenthetically that in the opinion sought to be reconsidered it was erroneously stated "We are not told the reason for including this cancellation clause."

Assuredly, prior to the exercise of the termination clause, taxpayers here "had an economic interest in the oil [coal] in place through its [their] control over extraction." Burton-Sutton Oil Co., Inc. v. Commissioner, 328 U.S. 25, 34 (1946). That control, moreover, actually existed, as already said, until the property was mined to exhaustion. Further, as stated in Burton-Sutton Oil Co. "Depletion depends only upon production".

It is the possibility of profit from the use of rights over production dependent upon the extraction of the mineral which marks an economic interest. No money need be invested in the mineral deposit. Commissioner v. Southwest Exploration Co., 350 U.S., at page 312.

There is no room for doubt that the taxpayers had the requisite control over production, for under the contracts, the Coal Company gave to taxpayers the exclusive right to mine all of the merchantable coal in place in the leased area. That such right might have been brought to an end does not affect the present fact that the economic interest existed.

There is also no room for doubt that the taxpayers depended solely upon production for their return, since they received only the agreed price per ton for coal produced and delivered. Indeed, they bore all risks of mining, including, but not limited to, the finding and production of commercial quality coal in such quantities necessary to make operation profitable.

Until now, every appellate decision in this type of case, including our own decision in Commissioner v. Mammoth

1. Russell Huss testified (p. 60 N. T.) that the termination clause "was put in there in a form contract so as if they got hold of a contractor who was not reputable, who wouldn't live up to the contract, they could put him off the property without court action."

Coal Co., supra, has held that there is no requirement that the stripper must assume the risks of the ultimate market. To the extent that we now hold otherwise, we are in conflict with our decision in that case and with the decisions of the Fourth Circuit. We are also in conflict with the latest pronouncement of the Supreme Court, Commissioner v. Southwest Exploration Co., 350 U.S. at page 314, that the taxpayer must look solely to the extraction of the mineral for his return. That is what the taxpayers here had to do.

Although we said, in Commissioner v. Mammoth Coal Co., 229 F.2d at page 537, that "The facts in each case determine the result", I do not regard such declaration as an admission that the criteria to be applied are too vague to do so on other than the basis of "the reasonable man". To the facts must be applied statute and the specific rules pronounced by the Supreme Court in the interpretation of it. That is the teaching of Commissioner v. Southwest Exploration Co., supra.

I conclude, therefore, that the taxpayers during the taxable years involved had the requisite economic interest in the coal in place. This, to me, is the result required by the decisions of the Supreme Court, the Fourth Circuit, and this Court; and our present decision is inconsistent therewith.

Accordingly, I would grant rehearing and reverse the judgments of the district court.